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Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1620

FIRST NATIONAL BANK AND TRUST COMPANY IN ALTON,
Executor of the Estate of Joseph E. Knight,

Petitioner,

vs.

SAMUEL BERKE, Receiver of City Savings Association,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The City Savings Association receivership is one of the oldest pending cases in the federal judiciary.[1] In 1964, a class of City Savings' depositors filed suit against Joseph

[1] Indeed, this is the fourth time a case involving City Savings or the receivership has been before this Court. See 389 U.S. 332 (1967); 409 U.S. 1038 (1972); 415 U.S. 918 (1974). Various aspects of the receivership have been before the United States Court of Appeals in Chicago on numerous occasions. *See* 570 F.2d 187 (7th Cir. 1978); 485 F.2d 1251 (7th Cir. 1973); 469 F.2d 531 (7th Cir. 1972); 461 F.2d 544 (7th Cir. 1972); 416 F.2d 594 (7th Cir. 1969); 371 F.2d 374 (7th Cir. 1967).

E. Knight and others for securities fraud in connection with the bankruptcy of City Savings, an Illinois savings and loan association. This Court affirmed federal jurisdiction under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78(a) *et seq.*, in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). Thereafter, federal receivers were appointed to marshal City Savings' assets. *Tcherepnin v. Kirby*, 416 F.2d 594 (7th Cir. 1969).

The instant Petition For Certiorari is among the few remaining open matters in the receivership. The relevant opinions of the District Court are reported at 393 F.Supp. 1197 and 424 F.Supp. 778. The Seventh Circuit's affirmance of the District Court is reported at 570 F.2d 187.

QUESTION PRESENTED

Whether this Court should grant certiorari to review a judgment holding Joseph E. Knight, a state official, liable in tort under Illinois state law when the judgment does not conflict with a decision of this or any other Court and presents no federal question.

STATEMENT

City Savings Association, an uninsured Illinois savings and loan association, was looted of over $20 million by its President, C. Oran Mensik, in the late 1950's and early 1960's. Mensik accomplished this massive fraud by making fraudulent mortgage loans to bogus corporations that he controlled through nominees. *Tcherepnin v. Franz*, 485 F.2d 1251 (7th Cir. 1973). In the words of the District Court, the collapse of City Savings "is a chronicle of political intrigue and corruption perhaps unmatched in Illinois history." (A. 15)[2]

Joseph E. Knight was Director of the Illinois Department of Financial Institutions from January 1962 to April 1968.[3] (A. 24) During the early 1960's, Knight and his Department received mounting evidence that City Savings was being financially mismanaged. (*E.g.* A. 35) On June 26, 1964, months after he was aware of City Savings' hopeless insolvency, Knight belatedly took state custody of City Savings from Mensik and closed the institution. (A. 39) Shortly thereafter and at Knight's di-

[2] References (A. ....) are to Petitioner's Appendix herein. References to Petitioner's Petition for Certiorari are indicated as (Pet. ....).

[3] The State of Illinois Director of the Department of Financial Institutions had the responsibility to regulate Illinois savings and loan associations to guarantee their compliance with the Illinois Savings and Loan Act, *Ill. Rev. Stat.* 1963, Ch. 32, §§ 702(b), 841-864. (All references to the Act herein are to the 1963 Illinois Statutes.) The Act *inter alia* authorized the Director to conduct examinations, *Id.* § 842(a), to conduct audits, *Id.* § 843, to require reports, *Id.* § 844, to direct corrective action, *Id.* § 842(c), and to seize custody of an association if an association's capital was impaired or if the association was being conducted in a fraudulent, illegal or unsafe manner, *Id.* § 848.

rection, City Savings was placed in voluntary state liquidation under the Illinois Savings and Loan Act, *Ill. Rev. Stat.*, 1963, Ch. 32, §§ 701 *et seq.* (A. 12; A. 40-A. 49) In 1968, after reviewing the progress of the liquidation and the plight of the depositors, the District Court found that Knight's liquidation "was tainted with fraud from its inception" and appointed federal Receivers to manage the City Savings' estate. (A. 20)

One of the Receivers' very first actions was to sue Knight for multiple breaches of his statutory duties under the Illinois Savings and Loan Act and his utter failure to arrest Mensik's fraud. Petitioner, Knight's Executor, was substituted for Knight after Knight's death in 1973. In April 1975, the District Court entered summary judgment against the Executor on the liability issues and referred the matter of damages to a special master. (A. 14 *et seq.*) In December 1976, the Court approved the special master's damage findings and entered judgment. On appeal, the Seventh Circuit affirmed the judgment in all respects. (A. 1 *et seq.*)

REASONS FOR DENYING THE WRIT

I.

THERE IS NO CONFLICT OF DECISIONS

The Seventh Circuit held that Knight was not immune from suit under Illinois law for his wilful breach and utter disregard of his statutory obligations. Petitioner asserts that Knight was entitled to absolute immunity from suit and that the Seventh Circuit's holding on a question of state law conflicts with the decisions of this Court and the decisions of other federal courts of appeal. But each authority cited to sustain these bald assertions involved solely a question of federal law, either construing the Civil Rights Act of 1871, 42 U.S.C. § 1983, or interpreting the standards of federal law governing the immunity of federal employees from suit. *See, e.g., Scheuer v. Rhodes*, 416 U.S. 232 (1974); *Barr v. Matteo*, 360 U.S. 564 (1959). These decisions are plainly inapplicable to this case which concerns the immunity of a state employee under Illinois law. Indeed, petitioner concedes that "the substantive law of that State [Illinois] should apply." (Pet. at 12)

Like many states, Illinois accords its executive officials a qualified immunity from suit. Prosser *The Law Of Torts* § 132 at 989 (4th ed. 1971). Illinois law holds that a state official is liable in damages to those he injures if he negligently breaches a ministerial duty or if he wilfully and maliciously breaches a discretionary duty. *E.g., Hering v. Hilton*, 12 Ill.2d 559, 562, 147 N.E.2d 311 (1958); *Myers v. Krajefska*, 8 Ill.2d 322, 329, 134 N.E.2d 277 (1956); *People ex rel. Munson v. Bartels*, 138 Ill. 322, 328, 27 N.E. 1091, 1092 (1891); *Gilbert v. Bone*, 64 Ill. 518, 524 (1872); *Paoli v. Mason*, 325 Ill. App. 197, 209, 59 N.E.2d 499, 504 (1945). The Illinois

Appellate Court reaffirmed and applied these settled principles only a few months ago. *Hoffman v. Yack*, 57 Ill. App. 3d 744, 373 N.E.2d 486, 490 (1978).

Moreover and signally, even if Knight's liability were not a question of Illinois law, petitioner woefully misreads the federal decisions upon which it relies.[4] State executives have long been accorded only a qualified immunity from suit under Section 1983, *Scheuer v. Rhodes*, 416 U.S. 232, 247-48 (1974), and only this Term this Court held that federal officials are likewise accorded only a limited immunity from suit, *Butz v. Economou*, 46 U.S.L.W. 4952 (June 29, 1978).

Accordingly, the Seventh Circuit's affirmance of the District Court on the immunity issue conflicts with no decision of this or any other Court.

II.

NO FEDERAL QUESTION IS PRESENTED

Upon detailed reviews of the voluminous factual record in this case, the Seventh Circuit and the District Court both held that Knight was not immune from suit under Illinois law. Petitioner's "Questions Presented" now suggests for the first time in this litigation that Knight was immune from suit "under the Fourteenth Amendment to the Constitution of the United States." (Pet. at 2) No authority is offered to support this newly asserted claim. None can be. The Fourteenth Amendment simply has no bearing on the common law prin-

[4] Petitioner also contends that Knight had no notice of the Receiver's claim because the Receiver's complaint did not allege *in haec verba* intentional misconduct and that the Receiver had no standing to sue Knight because Knight owed no duty to the unfortunate City Savings depositors. (Pet. at 15-17) The Courts below correctly rejected these contentions. (A. 6; A. 30-31)

ciples of Illinois tort law that are at issue here. Accordingly, petitioner presents no federal question—much less an important and substantial one—that calls for this Court's resolution.

III.

THE JUDGMENTS OF THE COURT OF APPEALS AND THE DISTRICT COURT WERE CORRECT

Courts across the Nation have held state banking officials and their sureties liable for knowingly permitting an unsound financial institution to remain open. *Crews v. American Surety Co. of New York*, 188 Okla. 486, 110 P.2d 1108 (1941); *Gormley v. State*, 54 Ga. App. 843, 189 S.E. 288 (1936); *Fidelity & Deposit Co. of Maryland v. Ware*, 47 Ariz. 12, 53 P. 2d 415 (1936); *Button v. Nevin*, 44 Ariz. 247, 36 P.2d 568 (1934); *Allen v. Title Guaranty & Surety Co.*, 27 Idaho 752, 152 P. 189 (1915); *Mills v. American Surety of New York*, 26 Idaho 652, 145 P. 1097 (1914). Thus as a matter of law the Seventh Circuit's affirmance of the District Court is in no sense unique. What is truly unique is the enormity of Mensik's fraud—the depositors were bilked of over $20 million—and Knight's inexplicable failure to prevent or halt it, knowing, as he did, of City Savings' financial instability and of Mensik's notorious disregard for safe banking practices.

When Knight became Director of the Illinois Department of Financial Institutions in 1962, Mensik's machinations at City Savings were already infamous. In 1957, the State of Illinois had closed City Savings for inflated mortgage lending and capital impairment. *Mensik v. Smith*, 18 Ill. 2d 572, 166 N.E.2d 265 (1960). In 1957, the Federal Home Loan Bank Board had refused to insure City Savings, finding that its financial policies and management were dangerously unsafe. (A. 9) In 1958,

Mensik was first indicted for mail fraud for financial chicanery concerning Maryland savings and loan associations. (In 1963 Mensik was convicted.) *United States v. Grow*, 394 F.2d 182 (4th Cir. 1968). And, in January 1962, the United States Tax Court found that Mensik had engaged in sundry frauds and irregularities at City Savings. 37 T.C. 703, *aff'd*, 328 F.2d 147 (7th Cir. 1964), *cert. denied*, 379 U.S. 827. Knight was fully aware of this sordid record of sharp dealing but allowed Mensik's looting of City Savings to continue unabated.

After 1962 the reports and audits filed by Mensik and others with Knight and his Department were ever more alarming. These documents chronicle repeated violations of the Illinois Savings and Loan Act, unsafe lending, inadequate internal controls, "unusual" expenses, and improper accounting practices. Knight paid no heed to these portents of disaster.

Knight's treatment of Mensik's dividend declarations typifies his cavalier disregard of the law. The Savings and Loan Act plainly states that City Savings could not pay dividends if its reserves were inadequate. *Ill. Rev. Stat.*, 1963, Ch. 32, §§ 779, 780. Knight admitted that he knew City Savings' reserves were inadequate in 1963. Indeed, as Knight's aide at the time put it, City Savings' reserves were not sufficient to cover even the smallest loss. Incredibly, Knight nevertheless permitted Mensik to pay dividends as if City Savings were Fort Knox rather than the bankrupt repository of thousands of depositors' uninsured life savings. (A. 37, A. 38)

By January 1964, Knight was advised that City Savings was in "bad trouble" and that Mensik had made inflated mortgage loans in two subdivisions in suburban Chicago. An overwhelming 82 percent of City Savings' loan portfolio was concentrated in these two projects, and Knight himself admitted that he knew that the ma-

jority of Mensik's loans were made to building corporations controlled by the same individuals. (A. 8, A. 9) By any measure of common sense, this huge concentration of suspect loans spelled fraud. Knight's continued inaction in the face of such reports belies any claim that he was acting in "good faith in allowing the bank to continue business." *Fidelity & Deposit Co. of Maryland v. Ware*, 47 Ariz. 12, 53 P.2d 415 (1936).

Knight further admitted that in March 1964 he knew that City Savings had a capital impairment of millions of dollars. Yet, he did not seize custody of City Savings from Mensik until June 30, 1964. By then City Savings had completely run out of money. By then Knight knew that City Savings' capital impairment exceeded $14 million and that the depositors would never recover the money Mensik had spirited away.

Inexplicably, Knight then knowingly concealed Mensik's fraud and the $14 million capital impairment from the depositors. Through his agents and with Mensik's assistance, Knight persuaded City Savings' depositors to adopt a plan of voluntary liquidation under the Illinois Savings and Loan Act. Mensik promised the depositors that they would receive "every nickel" and "100 cents on the dollar" of their deposits if, as the Act required, they approved the liquidation. Knight candidly conceded that Mensik's promises were outright falsehoods and took no steps to apprise the depositors of their true plight. Tragically, the Knight-directed liquidation that followed never recovered a penny of Mensik's ill-gotten gains. Knight's active concealment of the truth constitutes fraud and forecloses any claim that he was acting in good faith. *E.g., Endsley v. Johns*, 120 Ill. 469, 12 N.E. 247 (1887); *Forest Preserve District of Cook County v. Christopher*, 321 Ill. App. 91, 52 N.E.2d 313 (1944).

Knight's voluntary liquidation was not only fraudulently procured, it was in patent violation of the Savings and Loan Act.[5] The Act required Knight to appoint a receiver to dissolve City Savings if the reasons for seizing custody persisted, and it prohibited transfer of City Savings' assets to voluntary liquidators unless the causes of seizure had been completely eliminated. *Ill. Rev. Stat.*, 1963, Ch. 32, §§ 921, 854. Despite these clear statutory commands, Knight transferred City Savings' assets to voluntary liquidators even though he admitted that the causes of seizure (including the $14 million capital impairment) had not been cured. (A. 10-A. 12) This wanton disregard of mandatory ministerial duties renders Knight liable. *Button v. Nevin*, 44 Ariz. 247, 36 P.2d 568, 571 (1934); *Crews v. American Surety Co. of New York*, 188 Okla. 486, 110 P.2d 1108 (1941); *Gilbert v. Bone*, 64 Ill. 518 (1872).

While we could further detail Knight's complicity in the City Savings debacle, such discourse would serve no purpose. From the little we have presented, we think it plain, and two courts below have agreed, that Knight

[5] Petitioner claims that the involuntary liquidation provisions of the Illinois Savings and Loan Act have no application to this case. *Ill. Rev. Stat.*, 1963, Ch. 32, §§ 920 *et seq.* (Pet. 18-20). Like Knight in 1964, Petitioner wholly disregards the Illinois statutes. By statute, Knight had no business relinquishing custody of City Savings to voluntary liquidators so long as the causes for his taking custody had not been removed. *Id.* § 854. So long as the causes for taking custody persisted, Knight had a duty to place City Savings in involuntary liquidation:

> Section 921. *Director to Appoint Receiver.* If the Director, after taking custody of an association under the section of this Act concerning the Director's Authority to Take Custody, *finds that any one or more of the reasons for taking custody continues to exist through the period of his custody*, then *he shall appoint* any qualified person, firm or corporation as receiver or co-receiver of such association or trust for the purpose of liquidation. . . . *Id.* § 921 (emphasis supplied).

is liable to City Savings' depositors for his wilful and unprecedented wrongdoing under Illinois law. There is no cause to invoke this Court's discretionary review.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the Executor's Petition for Certiorari should be denied.

Respectfully submitted,

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